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GOVERNMENT SECURITIES ACT AMENDMENTS OF 1991

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 1247

JULY 29 (legislative day, JULY 8), 1991.—Ordered to be printed

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Mr. RIEGLE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

[To accompany S. 1247]

INTRODUCTION

On July 10, 1991, the Senate Committee on Banking, Housing, and Urban Affairs marked up and ordered to be reported a bill, the Government Securities Act Amendments of 1991, to amend the Securities Exchange Act of 1934 (Exchange Act) to ensure the efficient and fair operation of the government securities market, in order to protect investors and facilitate government borrowing at the lowest possible cost to taxpayers. The Committee voted to adopt the bill by a voice vote, without objection, and to report the bill to the Senate with the recommendation that the bill do pass.

PURPOSE AND SUMMARY

The Government Securities Act Amendments of 1991 has four major purposes. First, the legislation permanently extends the authority of the Department of the Treasury (Treasury) to write specified rules for government securities brokers and dealers. Second, the legislation authorizes the National Association of Securities Dealers (NASD) and the appropriate regulatory agencies for financial institutions to develop and implement sales practice rules for government securities dealers. Third, the legislation provides for full disclosure to customers of government securities dealers whose accounts are not insured by the Securities Investor Protection Corporation (SIPC). Fourth, the legislation directs the Treasury, the Board of Governors of the Federal Reserve System (Federal Reserve), and the Securities and Exchange Commission (SEC) to monitor and evaluate the effectiveness of private sector efforts to dis-

seminate government securities price and volume information, and to report their findings to Congress.

1. Reauthorization of the Treasury's rulemaking authority

Under the Government Securities Act of 1986 (GSA or Act), the authority granted to the Treasury to write rules related to capital and financial responsibility, record-keeping, reports, customer protection and securities custody requirements expires October 1, 1991. All witnesses and commentators before the Committee, including the General Accounting Office (GAO) and federal regulatory agencies, said that the Treasury has done an excellent job implementing its authority under the Act and that its authority should be reauthorized. The legislation, therefore, removes the expiration date for the Treasury's authority and permanently extends its authority to write rules in the areas designated under the GSA.

2. Sales practice rulemaking authority

When the GSA was adopted, Congress determined that, given the institutional nature of the government securities market, as well as the need to promote efficiency in the trading of government securities, sales practice rules similar to those applicable to the trading of other securities were not warranted. More recently, the GAO and some other commentators, while noting that incidences of abusive sales practices have not been widespread, have expressed concerns that the absence of fair dealing rules makes transactions in government securities potentially vulnerable to abusive dealer practices. The legislation addresses these concerns by providing authority for the application of sales practice rules to government securities brokers and dealers that are not already subject to such rules. For financial institutions that are government securities brokers or dealers, the appropriate regulatory agency would be authorized to write rules "necessary to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade." For securities firms that are government securities dealers and members of the NASD, the NASD would be authorized to write these rules, subject to approval by the SEC. The appropriate regulatory agencies for financial institutions and the SEC would be required to consult with the Treasury prior to adopting, approving or amending these rules and would not be permitted to adopt, approve, or amend a rule if the Treasury determined that the rule adversely affects the liquidity or efficiency of the market or imposes any unnecessary burden on competition. In addition, if the Treasury determines that an existing rule promulgated under this authority has an adverse effect on the liquidity or efficiency of the market for government securities or imposes an unnecessary burden on competition, the Committee intends that these concerns would be addressed by the appropriate parties. The legislation also would require regulators to consider the sufficiency of existing rules before adopting, approving, or amending new rules.

3. Disclosure relating to SIPC coverage

The SIPC insures the securities and cash in the customer accounts of member broker-dealer firms against the failure of those

firms. However, while all diversified securities broker-dealers registered with the SEC are required to be members of SIPC, the approximately 64 specialist government securities firms registered under Section 15(a)(1)(A) of the Exchange Act are not. The legislation prohibits government securities dealers that are not members of SIPC from effecting transactions in securities in contravention of SEC rules to assure that customers receive complete disclosure on the inapplicability of SIPC coverage to their accounts.

4. Study relating to government securities price and volume information

In the government securities market, seven interdealer brokers operate screen systems through which most trading by primary and aspiring primary dealers takes place. These brokers enhance liquidity by enabling dealers to trade large quantities of securities quickly and anonymously. Dealers who use screen brokers communicate their bid and asking prices and instructions to buy or sell to these interdealer brokers. The quotation information and resulting trading activity are displayed on a network of video screens that the brokers have installed in the dealers' trading rooms. In addition, dealers trade directly with one another over the telephone. The GAO, the Treasury and the SEC have recommended that Congress authorize rules to require the wider dissemination of government securities pricing and volume information. The Federal Reserve has opposed such legislation. Recently, private systems for the broad dissemination of pricing and volume information have become operational. The legislation, therefore, directs the Treasury, the SEC and Federal Reserve to monitor and evaluate the effectiveness of private sector efforts to disseminate government securities price and volume information and to report back to Congress in 18 months.

HISTORY OF THE LEGISLATION

The Government Securities Act Amendments of 1991, S. 1247, was introduced by Senators Dodd and Gramm at the request of the Treasury on June 6, 1991.

The Government Securities Act of 1986, P.L. 99-571, added a new section 15C to the Exchange Act and gave the Treasury authority to issue orders and to propose and adopt rules under Section 15C. Subsection 15C(g)(1) provides that the authority of the Secretary shall terminate on October 1, 1991. Section 103 of the Act provided for a study by the Treasury, together with the SEC and the Federal Reserve, to evaluate the effectiveness of the rules promulgated pursuant to section 15C in effecting the purposes of the Act and to submit to Congress recommendations with respect to the extension of the Treasury's authority, as well as other recommendations. Section 103 further directed the GAO to study the effectiveness of the regulation of government securities brokers and dealers and to report to Congress recommendations with respect to the extension of the Treasury's authority, as well as other recommendations. Section 104 of the Act further directed the GAO, in coordination and consultation with the Treasury, the Federal Reserve and the SEC, to study the nature of the trading system in the secondary market

for government securities and to report to Congress within six months from the date of enactment of the Act.

On December 18, 1987, the GAO issued a report, "U.S. Government Securities: An Examination of Views Expressed About Access to Broker's Screens," which concluded that access to transaction information from interdealer brokers' screens should be expanded and that market participants should be given time voluntarily to expand access.

In a September 1990 report, "U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed," the GAO recommended that the Treasury's rulemaking authority be reauthorized. The GAO also recommended that Congress authorize sales practice rules for government securities brokers and dealers, that Congress authorize rulemaking to require expanded access to pricing and volume information for government securities trading, and that SIPC insurance coverage be extended to customers of all government securities dealers.

In October 1990, the Treasury, the SEC, and the Federal Reserve submitted a joint report, "Study of the Effectiveness of the Implementation of the Government Securities Act of 1986" (Joint Report), which recommended that the Treasury's rulemaking authority be reauthorized and that further technical amendments to the GSA be adopted. The Joint Report noted that the participants in the study did not reach a consensus with respect to the need for sales practice rules, expanded access to pricing and volume information, and expansion of SIPC coverage.

On November 19, 1990, Senators Dodd and Heinz wrote to the SEC, requesting its views on the recommendations contained in the GAO study and other recommendations relating to the GSA. On December 10, 1990, Senators Dodd and Heinz wrote similar letters to the Treasury, the Federal Reserve, and other federal agencies, self-regulatory organizations and private sector groups, requesting their views on the GAO report, as well as the Joint Report. During the period from January through April 1, 1991, responses to the letters were received from the following: the Treasury; the Federal Reserve; the SEC; the Federal Deposit Insurance Corporation (FDIC); the Comptroller of the Currency; the Office of Thrift Supervision; the Department of Housing and Urban Development, the Government National Mortgage Association; the Federal National Mortgage Association; the SIPC; the NASD; the New York Stock Exchange; the Government Finance Officers Association; the Public Securities Association; and the American Bankers Association.

On June 6, 1991, the Treasury submitted proposed legislation to amend the GSA by reauthorizing the Treasury's rulemaking authority and making further amendments to the Act. The legislation was introduced by Senators Dodd and Gramm (by request) as S. 1247.

On June 12, 1991, the Subcommittee on Securities held a hearing on S. 1247, at which the following witnesses testified: Robert R. Glauber, Under Secretary of the Treasury for Finance; Richard C. Breeden, Chairman of the SEC; John P. LaWare, Member of the Federal Reserve; Joseph Hardiman, President of the NASD; Robert V. Stout, on behalf of the Government Finance Officers Associa-

tion; and Jon S. Corzine, on behalf of the Public Securities Association.

On July 10, 1991, the Committee marked up and reported S. 1247, containing substantial amendments to the bill as introduced.

PURPOSE AND SCOPE OF THE LEGISLATION

Background

The U.S. government securities market is one of the largest and most liquid securities markets in the world. At the end of 1990, there were approximately $3.7 trillion of government securities outstanding. This included Treasury debt securities (bonds, notes and bills) and securities issued or guaranteed by Federal government agencies and government-sponsored enterprises (securities of the Farm Credit System, the Federal Home Loan Bank System, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association and securities guaranteed by the Government National Mortgage Association). Treasury securities dominate the market, however. As of year end 1990, there were more than $2.2 trillion in marketable Treasury debt securities outstanding. Average daily trading volume in Treasury securities by primary dealers alone was approximately $115 billion in 1990.

Unlike corporate securities generally, government securities are exempt from the registration and disclosure requirements of the Federal securities laws. Until 1986, brokers and dealers who engaged solely in transactions in government securities were exempt from the registration, financial responsibility and other securities law requirements applicable to broker-dealers, although the antifraud provisions of the securities laws applied (and continue to apply) to the sale of government securities.

The failure of several government securities firms in the early 1980s led to substantial losses by a number of thrifts and municipalities who traded with those firms, and raised questions about the continued wisdom of exempting government securities firms from broker-dealer regulation under the securities laws. Congress responded in 1986 with passage of the Government Securities Act, which gave the Treasury authority to write rules relating to financial responsibility, customer protection, securities custody requirements, and related recordkeeping and reporting requirements for government securities brokers and dealers. The Act also established registration and notice requirements for government securities brokers and dealers. According to the SEC, as of March 31, 1991, the Act covered 240 financial institutions, 1,452 diversified securities firms and 64 specialist firms that trade government securities. Of these institutions and firms, there currently are 40 primary dealers, the group of securities firms and banks with whom the Federal Reserve Bank of New York conducts its open market transactions.

Under the Act, the Treasury's authority expires October 1, 1991 unless it is reauthorized by Congress. On June 6, 1991, the Treasury submitted legislation to (1) reauthorize the Treasury's rulemaking authority; (2) authorize the Treasury to write broad, general rules related to "fraudulent, deceptive and manipulative acts and practices" in government securities; (3) authorize the Treasury to

write sales practice rules related to just and equitable principles of trade for financial institutions that are government securities brokers or dealers and authorize the NASD to write consistent sales practice rules for diversified and specialist securities firms that are government securities brokers and dealers, and (4) authorize the Treasury to write rules requiring dissemination of price and volume information relating to government securities trading. While the Committee was in substantial agreement with the Treasury on the need to reauthorize its authority and make certain other amendments to the Act, the Committee revised the legislation consistent with the information submitted by numerous witnesses and other commentators before the Securities Subcommittee.

Extension of Treasury's rulemaking authority

Section 15C(g)(1) of the GSA provides that the authority of the Secretary of the Treasury (Treasury) to issue orders and to propose and adopt rules under the GSA terminates on October 1, 1991. All orders and rules which have been issued or adopted by the Treasury and which are in effect on October 1, 1991 will continue in effect according to their terms after that date. The authority of the appropriate regulatory agencies and self-regulatory organizations to enforce the registration and other requirements of the GSA and the rules thereunder also will continue in effect. However, in the absence of legislation reauthorizing the Treasury's authority or placing rulemaking authority in another department or agency, the GSA will not have the flexibility to respond to new developments and the evolving needs of investors and other participants in the government securities market.

As the Joint Report of the Treasury, the SEC and the Federal Reserve noted, "[t]he rules have been timely and fairly implemented; have not imposed excessive and overly burdensome requirements; have not impaired the liquidity, efficiency and integrity of the government securities market; and have improved and strengthened investor safety in the market." Every commentator and witness before the Securities Subcommittee said that the Treasury had done an excellent job implementing its authority under the GSA and that its authority should be reauthorized.

The Committee reaffirms the decision of Congress in adopting the GSA, that, because of the Treasury's knowledge of the market and responsibility for managing the public debt, the Treasury is in the best position to assure that rules adopted under the Act do not inadvertently damage the market. As noted by the GAO in its September 1990 report, "such damage could make it harder for the government to sell its securities at the lowest possible cost." Moreover, the Committee believes that preserving the current regulatory structure of the government securities market is necessary to ensure continuity of regulatory policy.

The majority of commentators and witnesses advocated extension of the Treasury's authority without recommending a new sunset date. These included the Federal Reserve, the SEC, and the FDIC, along with other governmental and private sector commentators. However, the GAO recommended extension of the Treasury's authority with a new sunset period. The Government Finance Offi-

cers Association (GFOA) recommended extension of the Treasury's existing rulemaking authority with a new sunset period for any new rulemaking authority.

The Committee does not believe a new sunset period is necessary. In the five years since adoption of the GSA, Congress has had ample opportunity to observe the Treasury's implementation of the GSA. The amendments contained in S. 1247 reauthorize the Treasury's existing authority and authorize a consultative role for the Treasury with respect to sales practice rules promulgated by other agencies. In view of the Treasury's experience implementing rules under the GSA, the Committee believes it is appropriate to extend the Treasury's existing authority and provide the new authority contained in the legislation without a sunset date. The legislation, therefore, permanently extends the Treasury's authority.

Sales practice rulemaking authority

In passing the GSA, Congress determined that it was necessary immediately to address known problems, such as the existence of unregulated dealers, the absence of financial responsibility requirements for those dealers, and inadequate standards and protections relating to the custody of securities subject to repurchase agreements. Given the institutional nature of the government securities market, as well as the need to promote efficiency in the trading of government securities, Congress, at that time, determined that sales practice rules similar to those applicable to the trading of other securities were not warranted. However, GAO's September 1990 report recommended that sales practice rules be authorized for the government securities market. Although its report acknowledged that there had been no record of widespread sales practice abuse, GAO noted:

> In the markets for registered corporate and municipal securities, self-regulatory organizations enforce SEC-approved rules of fair dealing that supplement SEC's antifraud rules. These rules cover the reasonableness of price mark-ups and the suitability of the match between the risk characteristics of a security and the needs of a purchaser. This element of investor protection is missing in the government securities market.
>
> * * * the National Association of Securities Dealers, the securities regulatory organization with the most explicit rules on price mark-ups and investor suitability, is not permitted under the act to apply such rules to the government securities transactions of the nearly 1,400 dealers and brokers it examines.
>
> GAO believes that the absence of fair dealing rules * * * makes transactions in government securities by some individuals and smaller institutional investors potentially vulnerable to abusive dealer practices. This is particularly true because in recent years securities have been developed in the government securities markets that have risk characteristics similar to those in registered markets [for example, zero coupon bonds and mortgage-backed securities].

A number of witnesses and commentators, including the Treasury, the NASD, the New York Stock Exchange, and the GFOA, support the authorization of sales practice rules for the government securities market. The GFOA, a national association of 12,400 state and local government officials whose responsibilities include public finance and cash management for state and local governments, has been the strongest advocate for sales practice rules for government securities dealers. Mr. Robert Stout, testifying on behalf of the GFOA, noted that state and local governments are significant buyers and sellers of government securities. According to 1987 census estimates, 30 percent of the total cash and security holdings of municipalities is in government securities. As of the first quarter of 1990, state and local governments held approximately 20 percent of all government securities not held by foreign investors or federal agencies. Mr. Stout noted that many of these investors are small governments. Of the 38,933 general purpose units of government, 85 percent have populations under 10,000. He further observed that, while even the smallest governments have significant amounts of tax receipts to invest, their finance officers may lack expertise in all areas of investment. He noted that the GFOA is particularly concerned about abusive practices regarding suitability, markups, and churning.

Accordingly, the GFOA urged the Subcommittee to grant a federal agency rulemaking authority for sales practice rules and to lift the restriction on the NASD in enforcing sales practice rules for its membership. The GFOA further urged that new sales practice rules should be appropriately similar to those of other regulated securities markets.

Mr. Jon Corzine, testifying on behalf of the Public Securities Association (PSA), a trade association representing approximately 300 banks, dealers and brokers that underwrite, trade and distribute U.S. government and municipal securities, said "PSA would not oppose reasonable rules of fair practice that, for example, prohibit excessive mark-ups and churning and promote suitability of investments." However, he noted that, "such rules must be tailored to the government securities market, the variety of securities it encompasses and the speed at which transactions are executed." His testimony set forth a number of principles PSA believes should be embodied in sales practice rules.

The Treasury also supports sales practice rules for the government securities market. In his testimony before the Securities Subcommittee, Treasury Under Secretary Glauber said, "The magnitude and the severity of abusive sales practices in the government securities market are difficult to assess, given the lack of specific evidence of widespread abuse." He noted, however, "Treasury clearly wants to prevent unscrupulous brokers and dealers who may have operated in * * * other markets * * * from moving into the government securities market." SEC Chairman Breeden testified that, while the NASD has brought several disciplinary actions for fraudulent sales practices in connection with the sale of government securities, "The SEC's own broker-dealer examination program has not found significant sales practice abuse by broker-dealers selling government securities." Nonetheless, he said removing the prohibition in current law that prevents the NASD from

applying its sales practice rules to its members' government securities activities is a "reasonable way to improve investor protection."

Joseph Hardiman, President of the NASD, testified, "[A]s the government securities markets have grown in size and complexity, the potential for abuse has been increasing, especially as individual, municipal and small institutional investors in recent years increasingly seek what they believe is greater safety in investments related to a government security." But, he noted, "Abuses in the government securities markets generally do not involve primary dealer activity in purchasing those securities from the government and then selling them to sophisticated institutional buyers or other dealers." He said the problem area is in the secondary market, "mostly involving unsophisticated institutional and individual customers."

Other witnesses and commentators believe sales practice rules are not necessary and may be potentially detrimental to the efficiency of the government securities market. In a letter to the Securities Subcommittee, FDIC Chairman Seidman noted that examinations of bank government securities dealers had revealed no instances of sales practice abuses. Moreover, he stated that bank examiners routinely apply sales practice rules of the Municipal Securities Rulemaking Board as a guide for government securities. Thus, the FDIC did not support the recommendation that there be sales practice rules for government securities dealers.

Federal Reserve Governor LaWare testified that, in the Federal Reserve's view, a convincing case for sales practice regulation has not yet been made. He warned, "It [is] absolutely essential to preserve the extraordinary liquidity and efficiency of the government securities market. This liquidity both facilitates the implementation of monetary policy through open market operations, and allows the Treasury to issue Federal debt at the lowest possible cost to the taxpayers." He noted that investor protection is a legitimate concern, because "a loss of investor confidence in the fairness and functioning of the government securities market could itself impair liquidity." However, he urged that care be taken to ensure that the "expected benefits of any new regulation exceed the associated expected costs."

Governor LaWare expressed concern that "suitability rules could impose a burden on the government securities market by adding to cost, delaying the execution of transactions and potentially limiting the range of legitimate investments available to a dealer's customers." He noted that, while "it is doubtful that any suitability rules should apply to those best described as institutional investors * * * [t]here are nevertheless concerns that smaller and perhaps less sophisticated investors may at times [have] been subjected to high pressure sales tactics and sold inappropriate investments." Consequently, the Federal Reserve did not object to removing the prohibition in current law that prevents the NASD from applying its sales practice rules to the government securities activities of its members. However, the Federal Reserve did not believe new sales practice rules for financial institutions were justified.

The legislation initially submitted by the Treasury would give the Treasury authority to write broad, general rules related to "fraudulent, deceptive and manipulative acts and practices" with

respect to transactions in government securities. The legislation proposed by the Treasury also would give the Treasury authority to write rules related to "just and equitable principles of trade" (which could include rules relating to markups and suitability) for financial institutions that are government securities dealers. Under the Treasury proposal, the NASD, subject to SEC oversight, would be authorized to write rules in these areas for diversified and specialist government securities firms. The proposed legislation would require the SEC to consult with the Treasury prior to approving any NASD rules, and further require that NASD rules be consistent with the Treasury rules regarding fraudulent, manipulative and deceptive acts and practices.

In evaluating the need for legislation generally, and the Treasury's proposal specifically, the Committee acknowledged that the weight of the evidence and testimony indicated that there has been no record of widespread sales practice abuse. Indeed, market regulators, dealers and investors have argued that sales practice rulemaking authority is warranted, primarily to address the potential for abuse. Accordingly, the Committee decided to authorize sales practice rulemaking authority, but determined to modify the Treasury's proposal to ensure that the market's efficiency would not be jeopardized by rules that were unnecessarily burdensome.

There was broad agreement on the desirability of lifting the restriction on the NASD, which currently prevents the organization from applying its sales practice rules to the government securities activities of its members. Accordingly, the legislation reported by the Committee removes current restrictions on the NASD under Section 15A(f)(2) of the Exchange Act by giving a registered securities association authority to write rules "to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade" with respect to the government securities activities of its members. The Committee notes the testimony of Joseph Hardiman, President of the NASD, who said the NASD "has historically applied its sales practices requirements with substantial input from the securities industry." In this connection, the Committee is encouraged that the PSA testified in support of the principal of applying fair sales practice rules to the government securities market, even though "abusive sales practice problems have not been widespread." The Committee believes that enlightened industry participation in the rulemaking process, together with industry efforts to ensure that unscrupulous dealers are deterred from taking advantage of unsophisticated investors, will ensure that the rules adopted will be tailored to address abusive practices without impeding the efficiency of the market.

With respect to Governor LaWare's concerns about suitability, Mr. Hardiman testified that "suitability requirements have been applied on a case by case basis with careful attention to the security involved, the sophistication of the customer, and the control over the investment decision. This careful balancing process ensures investor protection without—and I emphasize—without making the securities industry insurers [of] the performance of the investment itself." The Committee believes the NASD should continue to rely as much as possible on existing regulations and interpretations regarding sales practice rules. In addition, Section 4(c)(1) of the legis-

lation requires the SEC, in approving government securities sales practice rules filed by a registered securities association, to "consider the sufficiency and appropriateness of then existing laws and rules."

With respect to financial institutions that are government securities dealers, the Committee notes that there has been no evidence of abusive sales practices. Indeed, a number of witnesses testified that there is no need to authorize any federal regulatory agency to write sales practice rules for the government securities activities of financial institutions, since regulators in many respects apply existing rules related to municipal securities to the government securities activities of financial institutions. Therefore, instead of the approach proposed by the Treasury, Section 4(a) of the Committee bill adds a new Section 15C(b)(3) to the Exchange Act to specifically authorize the appropriate regulatory agencies for financial institutions to write rules "to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade."

In addition, new Section 15C(b)(3)(C) requires the appropriate regulatory agency, when determining whether or not to enact sales practice rules, to consider the sufficiency and appropriateness of existing laws and regulations. For example, in determining whether sales practice rules are necessary for bank and thrift dealer departments, the appropriate regulatory agency should consider that many bank dealer departments are effectively required to operate in accordance with the rules of the SEC, the NASD and the Municipal Securities Rulemaking Board, including applicable sales practice rules. While these rules do not specifically apply to many government securities transactions, bank examiners have required bank dealers to incorporate these sales practice rules into their government securities policies and procedures. Thus, some bank regulators examine these departments for compliance with those policies and procedures. Consequently, rather than duplicate compliance programs already in place and operating successfully, the appropriate regulatory agency may well determine under the discretionary authority granted to it by Section 15C(b)(3) that no need exists to promulgate new sales practice rules for bank dealer departments. Alternatively, the agency may determine to promulgate sales practice rules that largely conform to current bank dealer department practices.

In granting sales practice rulemaking authority to the NASD, subject to SEC oversight, and the appropriate regulatory agencies for financial institutions, the Committee does not expect that sales practice rules applicable to different types of government securities brokers and dealers—e.g., financial institution dealers and other securities dealers—necessarily would be identical or even that all appropriate regulatory agencies would adopt sales practice rules. However, the Committee intends that there be consistent levels of protection for investors in government securities. The Committee expects that the NASD or an appropriate regulatory agency would adopt sales practice rules if there were significant evidence of abuses by institutions subject to the appropriate regulatory agency's jurisdiction that would be prevented by the rules.

The legislation requires that, prior to the adoption or amendment of government securities sales practice rules by an appropriate regulatory agency for financial institutions, and prior to the SEC's approval or amendment of NASD government securities sales practice rules, the appropriate regulatory agency or the SEC must "consult with and consider the views of" the Treasury, except where an emergency exists requiring expeditious and summary action, and the reasons for taking such action are published. Under the legislation, if the Treasury comments in writing on a proposed rule or regulation or proposed amendment that has been published for comment, an appropriate regulatory agency or the SEC must respond in writing before approving the proposed rule or regulation. An appropriate regulatory agency or the SEC may approve a proposed rule, regulation or proposed amendment to a rule or regulation if the Treasury has not determined that the rule, regulation or amendment would, or as applied does, "adversely affect the liquidity or efficiency of the market for Government securities" or "impose any burden on competition not necessary or appropriate" in furtherance of the purposes of the Act. If the Treasury finds that an existing rule or regulation adopted under the authority granted in the legislation does not meet these conditions, it is the intent of the Committee that these concerns will be addressed by the appropriate parties.

The Committee believes it is important that the primary regulator, the NASD subject to SEC oversight in the case of its member securities firms and the appropriate regulatory agency in the case of financial institutions, have the primary sales practice rulemaking authority for institutions under its jurisdiction. This approach uses the expertise and experience of the regulators in implementing and enforcing sales practice rules, similar to their role with respect to the markets for other types of securities. At the same time, the Committee recognizes that the Treasury, with its strong interest in minimizing the cost to the taxpayer of financing the government debt by maintaining the liquidity, efficiency, and integrity of the government securities market, is in the best position to evaluate the actual or potential impact of sales practice rules on the liquidity and efficiency of the market. In addition, the Treasury is positioned to evaluate any anticompetitive effects of proposed rules or regulations by different regulators, and to evaluate these issues across the various regulators' jurisdictions.

The Committee does not intend that the Treasury would exercise its authority under this provision where there are mere differences of opinion as to the need for sales practice rules, or to specify the content of any particular rule. Moreover, it is not intended that the Treasury would force the SEC or an appropriate regulatory agency for financial institutions to adopt a more burdensome rule than one proposed, simply because another regulator has proposed or adopted a stronger rule. Instead, the Committee intends that the regulatory structure contained in the legislation will encourage the regulatory agencies for financial institutions, the self-regulatory organizations, the SEC and the Treasury to work together as sales practice rules are considered and developed. Such cooperation will assist in ensuring that rules that are adopted are necessary and appropriate, offer consistent protection for investors in differently

regulated entities, will not impair the liquidity or efficiency of the government securities market, and will not impose undue costs upon market participants.

Disclosure relating to SIPC coverage of customer accounts

The SIPC protects the securities and cash in the customer accounts of member broker-dealer firms against the failure of those firms. When a broker-dealer fails, SIPC protects customer cash and securities up to a maximum of $500,000 per customer (with a limit of $100,000 on cash). Under Section 3(a)(2)(A) of the Securities Investor Protection Act, all brokers or dealers registered under Section 15(b) of the Exchange Act are required to be members of SIPC, unless subject to a specific exemption. However, specialized brokers and dealers registered under Section 15C of the Exchange Act, whose securities business is limited to government and other exempt securities (except municipal securities), are not permitted to become members of SIPC. Thus, the approximately 64 specialist government securities firms are not SIPC members.

The GAO has argued that "this gap in SIPC coverage is not appropriate" and could be confusing to investors. Although it noted that a way to reduce the potential for confusion would be to "require specialist dealers to clearly disclose that they do not provide SIPC coverage," GAO expressed its view that it believed SIPC coverage should be extended to these dealers, in order to fully protect investors.

Most of the other commentators and witnesses before the Securities Subcommittee, including the Treasury, the Federal Reserve, the FDIC and private sector commentators, either declined to discuss the SIPC issue, or specifically noted that they did not take a position on the issue. The SEC argued that SIPC coverage should not be extended to specialized government securities brokers and dealers unless, as a "pre-condition," all restrictions on the NASD's rulemaking authority with respect to government securities dealers be eliminated. SIPC also commented on the need to address distinctions in regulation of specialized government securities dealers versus diversified dealers prior to extending SIPC coverage. The NASD supported GAO's recommendation to require SIPC coverage of all government securities firms, provided that all restrictions on NASD rulemaking are eliminated.

The legislation proposed by the Treasury did not address this issue. In view of the fact that there had been no record of abuse, the Committee determined that a disclosure approach was appropriate at this time. Therefore, the Committee adopted as part of its amendment to the bill an amendment to Section 15C(a) of the Exchange Act, providing that no government securities broker or dealer that is not a member of SIPC shall effect securities transac tions in contravention of rules that may be prescribed by the SEC to assure that customers receive complete, accurate and timely disclosure of the inapplicability of SIPC coverage to their accounts.

Access to price and volume information for government securities

In the government securities market, seven brokers, known as "screen brokers" or interdealer brokers, operate screen systems

through which most trading by primary and aspiring primary dealers takes place. These brokers enhance liquidity by enabling dealers to trade large quantities of securities quickly and anonymously. Dealers who use screen brokers give them their quotes (bid and asking prices) and instructions to buy or sell by telephone. The quotation information and resulting trading activity are displayed on a network of video screens that the brokers have installed in the dealers' trading rooms. According to the GAO report, as of January 31, 1990, six of the screen brokers provided access to their screen information only to 44 primary dealers (the number of primary dealers has since decreased) and five aspiring primary dealers. Only one screen broker provided information to a broad group of dealers and subscribers. The GAO reported that, in 1989, almost 60 percent of all primary dealer trading was conducted through screen brokers. Trading that is not conducted through screen brokers is conducted directly among dealers or between dealers and their customers.

When Congress adopted the GSA, it directed the GAO, in coordination with the Treasury, the SEC and the Federal Reserve, to study the trading system in the secondary market for government securities and to report to Congress six months after the enactment of the Act. In a 1987 report, the GAO concluded that access to transaction information from interdealer brokers' screens should be expanded, but said market participants should be given time to expand access voluntarily. However, in its more recent September 1990 report, GAO said, "Unfortunately, market participants have generally not done so. We therefore believe the point has been reached where legislative action is needed."

The Committee believes that expanded information access serves the public interest by enhancing customer protection and providing for fair competition among market participants. It enables customers to better evaluate the fairness of trades and ensures that a broad spectrum of market participants can obtain current and accurate details relating to market conditions. Access to more accurate price and volume information also enhances the ability of regulatory authorities and independent auditors to verify that securities transactions and positions have been properly valued. In turn, expanded information access will serve to maintain and improve the efficiency and liquidity of the government securities market, thereby lowering the costs to taxpayers of raising federal funds.

The Treasury and the SEC have strongly supported legislation to require expanded access to quotation and transaction information. The Public Securities Association has testified that it supports expanded access to government securities pricing information, but notes that PSA's industry joint venture information system, known as the Government Pricing Information System ("GOVPX"), has made legislation unnecessary at this point. However, in letters to the Securities Subcommittee, both the SEC and the Treasury expressed skepticism that the industry would have moved forward, absent the GAO's reports and the potential for legislation. The Treasury wrote the Subcommittee:

> We believe that the establishment of GOVPX was significantly influenced by the growing pressure for a federal

> regulatory presence in this area. Accordingly, federal regulatory authority is desirable to encourage further expansion of fair and reasonable access to government securities price information even though it might not be necessary to use this authority.

Thus, the Treasury proposed legislation that would have granted the Treasury authority to write rules to "assure the prompt, accurate, reliable, and fair reporting, collection, processing, distribution, and publication" of quotation information relating to government securities. Under the Treasury proposal, the Treasury's rulemaking authority would include rules to assure that "all government securities information processors" may obtain quotation and transaction information relating to government securities that may be prepared by other information processors, and that other persons may obtain the information on "terms which are not unreasonably discriminatory."

However, Federal Reserve Governor LaWare testified, "The issue of whether legislation is needed to expand access to information about securities trading through interdealer brokers appears at present to be very nearly moot." Referring to the GOVPX initiative, he observed, "we believe that so long as it is going forward, actual legislation and associated regulatory oversight are unnecessary and could constrain rapidly changing market practices." He further observed that the Federal Reserve's view may change, should this initiative falter.

It is noteworthy that SEC Chairman Breeden in his June 12, 1991 testimony before the Securities Subcommittee, also expressed concerns about the possible detrimental effect of rulemaking at this time. He said "We're very concerned whether the introduction at this preliminary stage, as this new system is coming in, of Federal rulemaking might in fact delay, rather than speed up the completion of a reporting system." Instead, the SEC supported limited "backstop" authority, which would be triggered in the future if the private system failed to meet certain objectives. While the SEC observed that there remain gaps in the system, Chairman Breeden noted: "We would hope that most gaps in the system could be filled in the reasonably near future as the system becomes operational and market participants gain actual experience. We therefore do not see any need to give any agency general immediate authority to require transaction and quotation reporting in the government securities market."

The Committee believes a broad new grant of statutory authority to mandate access to government securities price and volume information is unnecessary and inappropriate at this time. Private sector initiatives, such as GOVPX, are now in place and should be allowed additional time to develop. Moreover, since the private systems thus far have been responsive to regulatory and Congressional concerns, the Committee chose not to provide for backstop authority at this time. For example, both the Treasury and the SEC expressed concerns that GOVPX did not provide "best offer" information to participants, but only displayed the offer accompanying the best bid. However, subsequent to the Subcommittee's hearing, GOVPX announced that, as of July 7, 1991, it was enhancing the

system to provide best offer information for all Treasury securities prices it carries. Industry participants have indicated that still other enhancements are under consideration.

These initiatives are in their nascent stages, and changes to the systems may be necessary to respond to regulatory concerns and marketplace demands. The SEC and the Treasury both noted that GOVPX does not provide price and volume information for government securities that are not direct Treasury issues. The SEC also expressed concern that GOVPX does not "include the size associated with published bids and offers," does not include "other bids and offers available in the market," that "users will not be able to access or store data electronically for analytical purposes," that "GOVPX disseminates only the quotations placed with participating interdealer brokers" (leaving out 25 percent of the interdealer market), and that it will not "disseminate last-sale prices, volume, and quotations from government securities dealers if an interdealer broker is not utilized." The Committee expects that the private sector initiatives will consider system enhancements on a timely basis, and will give specific consideration to the concerns raised by the Treasury, the SEC and market participants.

The Committee believes market regulators must continue to monitor the development of private sector systems, as these systems respond to the concerns raised by the Treasury and the SEC and by market participants. Therefore, the legislation directs the Treasury, SEC and the Federal Reserve to "monitor and evaluate the effectiveness of private sector efforts to disseminate Government securities price and volume information." The agencies are directed to report their findings and recommendations to Congress eighteen months after the date of enactment of the legislation. The Committee intends to review carefully these recommendations and findings. If private sector initiatives have not responded appropriately to the concerns of the Treasury, the SEC and market participants, the Committee will reconsider the necessity of granting statutory authority to mandate access to government securities price and volume information.

SECTION-BY-SECTION ANALYSIS OF S. 1247

Section 1. Short title

This section states the title of the bill, the "Government Securities Act Amendments of 1991."

Section 2. Findings

This section sets forth Congressional findings as follows:

1. The liquid and efficient operation of the government securities market is essential to facilitate government borrowing at the lowest possible cost to taxpayers;

2. The fair and honest treatment of investors will strengthen the integrity and liquidity of the Government securities market;

3. Rules promulgated by the Secretary of the Treasury have worked well to protect investors from unregulated dealers and maintain the efficiency of the government securities market; and

4. Extending the authority of the Secretary and providing new authority will ensure the continued strength of the government securities market.

Section 3. Extension of the Treasury's authority

This section repeals section 15C(g) of the Securities Exchange Act of 1934, which provides that the authority of the Secretary of the Treasury to promulgate regulations and issue orders under the Government Securities Act expires October 1, 1991. The repeal of this provision permanently extends the authority of the Secretary with respect to rulemaking under the provisions of the Government Securities Act of 1986.

Section 4. Sales practice rulemaking authority

Subsection (a). Rules for financial institutions

This subsection amends Section 15C(b) of the Exchange Act to add a new subparagraph (3)(A), giving the appropriate regulatory agency for any financial institution that has filed notice as a government securities broker or dealer, or that is required to file notice, authority to write rules as may be necessary to prevent "fraudulent and manipulative acts and practices and to promote just and equitable principles of trade." A rule or regulation may be adopted if the Treasury has not determined that the rule or regulation would, or as applied does, adversely affect the liquidity or efficiency of the market for government securities, or impose any burden on competition not necessary or appropriate in furtherance of the purposes of the GSA.

New subparagraph (3)(B) requires the appropriate regulatory agency to consult with the Treasury prior to approving or amending a rule, except where an emergency exists requiring expeditious and summary action. Where the agency acts on an emergency basis, it must publish its reasons. Where the Treasury comments in writing on a proposed rule or regulation published for comment, the appropriate regulatory agency is required to respond in writing before approving the proposed rule or regulation.

New subparagraph (3)(C) directs the appropriate regulatory agency to "consider the sufficiency and appropriateness of then existing laws and rules" applicable to Government securities brokers and dealers and their associated persons.

Subsection (b). Rules by registered securities associations

This subsection amends Section 15A(f)(2) of the Exchange Act to give a registered securities association (the NASD) authority to write rules "to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade" with respect to transactions in Government securities.

Subsection (c). Oversight of registered securities associations

This subsection amends Section 19(b) of the Exchange Act, adding a new paragraph (5) requiring that the SEC consult with the Treasury prior to approving any rule filed by a registered securities association relating to government securities transactions, except in an emergency. The SEC may approve the rule, if the

Treasury has not made a determination that the rule or regulation would, or as applied does, adversely affect the liquidity or efficiency of the market for government securities, or impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

New paragraph (6) directs the SEC to "consider the sufficiency and appropriateness of then existing laws and rules" in approving rules filed by a registered securities association under the new law.

Section 19(c) is amended by adding new paragraph (5), requiring the SEC to consult with the Treasury before "abrogating, adding to, and deleting" from rules under the new provisions, except in an emergency.

Section 5. Disclosure by government securities brokers and government securities dealers whose accounts are not insured by the Securities Investor Protection Corporation

This section amends Section 15C(a) by redesignating paragraph (4) as paragraph (5) and inserting a new paragraph (4) providing that no government securities broker or dealer that is not a member of SIPC shall effect any transaction in any security in contravention of rules that may be prescribed by the SEC to assure that customers receive complete, accurate and timely disclosure of the inapplicability of SIPC coverage to their accounts.

Section 6. Technical amendment

This section amends Section 15C(d)(2) of the Exchange Act to clarify that information concerning any government securities broker or dealer may be provided to the Federal Reserve Banks as well as to the Board of Governors of the Federal Reserve System.

Section 7. Amendments to definitions

Paragraph (1) of this section conforms the definition of "appropriate regulatory agency" under section 3(a)(34)(G) of the Exchange Act with existing bank regulatory agency supervisory authorities.

First, the Federal Reserve would be designated as the appropriate regulatory agency for financial institutions that are Edge Act or Agreement corporations. Without this modification, supervisory responsibility for the government securities activities of these entities would continue to rest with the SEC. Since the Federal Reserve already exercises bank regulatory and supervisory responsibilities for these entities pursuant to the Federal Reserve Act, this amendment would eliminate inefficiencies and reduce costs resulting from duplicative examinations.

Second, the Federal Deposit Insurance Corporation (FDIC) would be designated as the appropriate regulatory agency for insured State branches of foreign banks (the Federal Reserve would retain jurisdiction for uninsured State branches and State agencies of foreign banks.) This amendment will ensure that the FDIC, which currently examines insured State branches of foreign banks pursuant to the International Banking Act, would be responsible for the examination of government securities activities conducted by such institutions. The amendment would eliminate the costs associated with duplicative examinations.

This provision also inserts a parenthetical reference to the definition of "savings association" contained in the Federal Deposit Insurance Act. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) amended clause (iv) to designate the Director of the OTS as the appropriate regulator for savings associations. The term "savings association," however, is not defined in the Act.

Paragraph (2) of this section would amend the definition of the term "financial institution" contained in section 3(a)(46) of the Exchange Act. Prior to FIRREA, section 3(a)(46) referenced the definition of "insured institutions" (including insured thrifts) contained in the National Housing Act (NHA). FIRREA, however, repealed the referenced NHA definition. The amendment would clarify the definition of "financial institution" by reincluding entities that were formerly insured by the Federal Savings and Loan Insurance Corporation. Consistent with FIRREA section 744(u), this provision would include savings associations insured by the FDIC and subject to supervision by the OTS within the definition of "financial institution."

Section 8. Study relating to government securities information

Paragraph (a) of this section provides for a study of these issues, as follows.

Section 8(a) provides that the Secretary of the Treasury, the SEC and the Federal Reserve shall "monitor and evaluate the effectiveness of private sector efforts to disseminate Government securities price and volume information" and determine whether the efforts—

(1) assure prompt and reliable reporting, collection and distribution of quotation information;

(2) assure that all Government securities information processors may obtain quotation information on fair and reasonable terms; and

(3) assure that persons can obtain information on terms which are not unreasonably discriminatory.

The term "government securities information processor" is intended to mean any person engaged in the business of collecting, processing, or preparing for distribution or publication information with respect to transactions in or quotations for any government security, as well as any person engaged in distributing or publishing such information on a current and continuing basis. It is not intended to include the press and common carriers subject to the jurisdiction of the Federal Communications Commission or a State commission, unless such carrier is engaged in the business of preparing for or coordinating the distribution or publication of such information.

Section 8(b) requires a report to Congress within 18 months from the date of enactment.

The title of the bill is amended to read: "A bill to amend the Securities Exchange Act of 1934 to ensure the efficient and fair operation of the Government securities market, in order to protect investors and facilitate Government borrowing at the lowest possible cost to taxpayers."

REGULATORY IMPACT STATEMENT

In compliance with paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement regarding the regulatory impact of the bill. This bill will extend Treasury's rulemaking authority with respect to government securities brokers and dealers, authorize sales practice rules for government securities dealers, authorize SEC rules relating to disclosure of the extent of insurance coverage of customer accounts at government securities brokers and dealers that are not members of SIPC, and require a study of government securities pricing and volume information. The Committee intends that these provisions be implemented with minimal overall increase in the regulatory burden.

COST OF THE LEGISLATION

The Committee has requested a cost estimate of this legislation under the provisions of Section 403 of the Congressional Budget Act of 1974. The cost estimate of the Congressional Budget Office follows.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, July 26, 1991.

Hon. DONALD W. RIEGLE,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed S. 1247, the Government Securities Act Amendments of 1991, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on July 10, 1991. CBO estimates that the bill would result in additional costs of $0.5 million for each of the fiscal years 1992 and 1993, and about $0.1 million annually thereafter, assuming appropriation of necessary amounts. This bill does not affect direct spending or receipts and therefore would not affect pay-as-you-go scoring.

Under current law, the Department of the Treasury has authority, which will expire on October 1, 1991, to write rules for government securities brokers and dealers. S. 1247 would permanently extend such authority. In addition, the bill would require the Securities and Exchange Commission (SEC) to issue rules ensuring that customers are informed when their accounts are not covered by the Securities Investor Protection Corporation. The SEC also would have to approve rules proposed by the National Association of Securities Dealers. Finally, S. 1247 would require the Secretary of the Treasury, the SEC, and the Federal Reserve to report to the Congress within 18 months on the effectiveness of private sector efforts to disseminate government securities price and volume information.

Based on information from the Department of the Treasury and the SEC, CBO estimates that the rulemaking and approval authority and the report to the Congress required by the bill would cost about $0.5 million per year in 1992 and 1993. In addition, extending Treasury's rulemaking authority would cost about $0.1 million annually over the 1994–1996 period.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are James Hearn and John Webb.

Sincerely,

ROBERT D. REISCHAUER,
Director.

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirement of subsection 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

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